competition rules, the inquiry we enunciated in D.95-07-054, the majority redefines and broadens the franchise impact issue. The new franchise impact inquiry as embodied in the Order is as follows:

> "whether our adopted new regulatory program embodied in the roadmap proceedings combined with the NRF-established depreciation methods will deprive them of the opportunity to earn a fair return on their 'regulated assets'." (d.96-09-089, Ordering Paragraph 7, p. 72.)

Before concluding the Order, the majority adds this guidance:

> "The carriers may concurrently recommend recovery mechanisms to mitigate any adverse effects of our regulatory policies. The carriers should specify who will be charged for the recovery. In their applications, the carriers should also specify what portion of their 'regulated assets' subject to our revised regulatory program should be considered in determining the impact of our policies." (D.96-09-089, Ordering Paragraph 7, p. 73.)

By adopting an expansive approach to the franchise impact inquiry, the majority introduces the high risk of creating a real, though unintended, barrier to the advent of full competition. The majority invites the proliferation of proceedings and extensive reargument of well-settled Commission positions, decided as long as seven years ago when the Commission adopted the New Regulatory Framework (NRF) (D89-10-031, 33 CPUC 2nd 43)

While the majority decision apparently provides the express opportunity for Pacific and GTEC to re-argue issues that were decided in 1995 and 1996, out of economic self interest and with nothing to lose, the carriers may attempt to re-argue all issues and decisions in which they did not originally prevail before the Commission. Most likely, they will seek to reverse our determination in D.96-03-020, (i.e. resale decision), that no taking had occurred. Literally, hundreds of calls were made within the 1994 Implementation Rate Design (IRD) decision that will be vulnerable to new claims of franchise loss and assertions of negative impact on the incumbent carriers. Conversely, some interveners might employ this opportunity to re-litigate the Airtouch decision and the 1995 NRF Review decision. The Southwestern Bell Corporation/Pacific Telesis merger application may also be implicated. In essence, the majority's broad reapplication invitation will serve as the unintended excuse for relitigation of ANY issue that has even a modicum of connection to local competition issues. NO issue will be safe or settled. The yoke of regulation will continue to be the albatross around the neck of the industry.

The present franchise impact case has been a time intensive inquiry and has taken nearly a year. It is not a pleasant thought to forecast how long it will take to complete the majority's new mega-proceeding, and how the sheer size and length of such a proceeding might adversely impact the evolution of competition.

This Commission, under Public Utilities Code section 1708, always retains the right to change previous Commission decisions. However, this broad inquiry sets a dangerous precedent that appears to subject all that was established in the march to competition to wholesale reevaluation. Such a belated assessment, or even the appearance thereof, could seriously undermine the entire enterprise to de-regulate, if not by actual changes in policies and rules, at least by the chilling effect such an inquiry will likely have on potential entrants to the newly opened market.

Electric Industry Framework Not Applicable

The majority concludes that ":[t]he fundamental similarity between the electric and telecommunications industries is their transition from monopoly to competitive environments and the role the commission plays in directing that transition. However, this similarity is far outweighed by the looming differences. The majority's decision spends a few scant lines stating that the situation between these industries is comparable. The majority's conclusionary statements are unpersuasive. The majority reaches the conclusion that the showing Pacific and GTEC made are not entirely inconsistent with the criteria the Commission laid out in its electric restructuring decision.[1] They cannot be more incorrect. In the electric restructuring decision, the Commission **did** allow the electric utilities to recover costs associated with uneconomic assets. However, the Commission refused to do so on the basis of the kind of speculative information offered by the Pacific Bell and GTEC. Rather the Commission simply stated that the utilities would be allowed to recover the difference between the market value of their assets and the book value of those same assets. There are three ways a utility may seek to establish a market value for these assets: 1) sell the asset, 2) spin the asset off to shareholders, or 3) seek a market valuation by an independent valuation expert. Each of these options are based upon the economic value of the asset and compares that to the book value of the asset. In addition, any assets with book values greater than their market value are netted out against those assets with a market value that exceeds the book value. **Neither Pacific nor GTEC calculated their "stranded assets" in a similar fashion.** Here it is important to note that the electric utilities had a market to book ratio much closer to 1:1 than was the case for either Pacific Bell or GTEC.

A second difference between the situation in the electric industry and the telecommunications

[1] I note that the language of the decision implies that in the majority's own minds, the showings are not entirely consistent with criteria established in our electric restructuring decision either.

industry is that the Commission has fundamentally altered the pricing of the utilities service offering in the electric industry. The electric utilities are directed to pass along to consumers only the cost of purchasing power in the Power Exchange to consumers. If this price is not sufficient for the utility to recover both its going-forward operating costs and its sunk costs, the electric utility is allowed to recover the difference. However the electric utility may do so only to the extent that rates do not raise above current levels. In the telecommunications industry, Pacific seeks to recover its "compensation" thorough an increase in rates above today's levels or through a surcharge on existing rates. **Hence, the electric utilities were seeking only to continue to recover those costs already in rates while Pacific is arguing for recovery of new, higher costs.** In essence, the electric utilities seek to unbundle their uneconomic stranded cost recovery from existing rates and seek recovery through a surcharge on those that continue to use its distribution system.

A third difference between the stranded cost issue for electric utilities and the circumstances facing the Commission in the telecommunication industry is that in the electric industry, the utilities are only provided an **opportunity** to recover these "stranded costs". The utilities are allowed to recover those costs that the market will allow recovery. The electric utilities are allowed to recover stranded investment only until December 31, 2001. There is no **guarantee** that the utility will fully recover these stranded costs.

In the electric industry, the California Legislature has spelled out very specific guidelines regarding how and when the utilities are allowed to recover uneconomic costs. Rates are frozen at 1996 levels and the utilities are able to forego future rate decreases that would otherwise occur, and use this amount to recover stranded costs. The utility is allowed to forgo these rate reductions and retain the revenues, only until the year 2002 or until the uneconomic costs are fully recovered. In addition, the utility is allowed a reduced rate of return because of the reduced risk of recovery of these uneconomic sunk costs. The utility is not guaranteed a fair rate of return, only a fair opportunity to earn a fair return. Furthermore, the utility explicitly described what costs are recoverable as uneconomic costs. This bears no resemblance to the scheme that the incumbent local telephone companies have in mind.

And finally, the majority overlooks the most fundamental difference between the electric utilities and the incumbent local exchange carriers. The electric companies were regulated under rigorous traditional cost of service regulation and each of the major investments for which the utility would be eligible for recovery were expressly approved by the Commission, which found their construction to be in the public interest. The local telephone companies have been regulated under the New Regulatory Framework (NRF) since 1990 and since then have been at risk for any and all uneconomic investments. In addition, the telecommunications industry was not subject to the same degree of review for the specific investments they now claim are uneconomic. The Commission has allowed the telecommunications business the flexibility to manage their own affairs, while it has retained cost of service regulation and reasonableness reviews for the regulation of the electric utilities. In essence, the electric utilities investment decisions were much more subject to specific commission oversight and hence, the responsibility of the Commission to assure recovery is heightened. This is not, and should not, be the case in telecommunications.

No Evidence of Impaired Ability to Earn Fair Return

As I reviewed the financial projections of Pacific and GTEC, they appeared to be overly pessimistic and to overstate the impact of regulatory changes on the present and prospective fortunes of the company. In fact, it could be argued that the constant pessimistic outlook that permeated Pacific's projections led the market to under value Pacific Telesis's stock, producing lackluster stock results and resulting in Southwestern Bell Corporation viewing the stock price favorably and hence spurring their proposed acquisition of Pacific Telesis.

Even the majority concludes that Pacific and GTEC did not adequately prove that the Commission's regulatory program would impair the carriers opportunity to earn. The evidence in this caseas put forth by Pacific and GTEC is not only speculative, it is utterly unpersuasive.

As I prepared for the vote on this case, I made a special effort to review Pacific's financial and business conditions. According to publicly available data regarding Pacific's stock price, as of September of 1996, Pacific Bell had outperformed all other companies in its stock price performance since July of 1995. In fact, it outperformed the S&P 500 over that same time period.

Pacific Bell is experiencing tremendous growth in its market. Pacific is coming off a record 2nd quarter, well on its way to a very good year. Pacific Telesis operating income for the first six months of 1996 increased a staggering 18%, $182 million, over the operating income for the first six moths of 1995. This increase in operating income resulted from a surge in revenues of 5.4% combined with a modest increase in expenses, including depreciation, of just 1.7 %. Net income increased by 6.8% reflecting a 5 cent gain, to 66 cents in earnings per share for the 2nd quarter of 1996 over 2nd quarter 1995.

> " Total access lines in service increased by a record 726,000 lines in 1996 or 4.7 percent year over year, as business access lines grew even faster than the record-setting pace of the first quarter, rising to 5.7 percent. Residential lines grew 4.2 percent year over year, up from a 3.1 percent annual growth rate

through the first quarter." [2]

The fact of the matter is that Pacific Bell is selling more access lines now than it did prior to the Commission opening the market. In fact, revenues for local service for the first six months of 1996 is up $99 million dollars over the same six months in 1995 an increase in local service revenues of 5.2%.

> "Toll market share loss of 6 percent was less than we expected, while the overall toll market grew at a strong rate -- 13 percent at year-end." Phil Quigley February 23, 1996 discussing 1995 results of operations. [3]

Pacific Bell reported revenues of $639 million in intrastate Toll revenues for the first six months of 1996. This represents an increase of 3.9% over the revenues for the first six months of 1995. Over the past 12 months Pacific Bell's revenues for intraLATA service has increased even in the face of competition. In fact, for the 2nd quarter of 1996, Pacific's IntraLATA toll revenues increased by 7.7% over the same period in 1995. Clearly, the growth of the toll markets is outstripping the losses to competition Pacific has faced. Despite a market share loss of about 6%, Pacific has seen tremendous growth in its toll revenues. For the first year of competition in the intraLATA toll market the rate of increase in the size of the market more than offset, by a factor of two, the loss of market share by Pacific..

> "Estimated access minutes-of-use for the second quarter continued to be strong, up a substantial 10.0 percent from the same period last year: 8.4 percent interstate; 11.9 percent intrastate." [4]

It is an undisputed fact that the access market is booming in California and Pacific Bell is well positioned in this competitive market. It can be argued that Pacific's low access rates are a competitive advantage because its access rates are the lowest in the country and could serve as a competitive deterrent compared to rates in other parts of the country.[5] Intrastate access revenues are up 6.1% for the first half of this year as compared to the first six months of 1995. This is true despite the Commission opening the transport market to competition in 1995 and the existence of several viable facilities-based carriers in this high capacity market. On the interstate side, revenues are also up increasing 5.6% over last year. Despite competition, Pacific has seen its access minutes and its access revenues increase.

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[2] Pacific Telesis Press Release *Pacific Telesis Reports Record Setting Increases IN New Customer Lines in Second Quarter*, July 18, 1996.

[3] Phil Quigley Letter to Shareowners, February 23, 1996

[4] Ibid

[5] UBS Securities Analysis and Buy Recommendation of Pacific Telesis, July 9, 1996

> " Accelerated demand for data services continued in the second quarter, as intensified marketing efforts drew more customers to Pacific Bell's FasTrak service family, including Integrated Services Digital Network (ISDN), Frame Relay, Switched Multi-megabit Digital Service and Asynchronous Transfer Mode. New lines placed in service for ISDN, ideal for high-speed telecommuting and Internet access, grew 129.4 percent year over year. Demand for high-capacity DS1 and DS3 lines is skyrocketing. DS1 lines grew three times as fast, and DS3 lines grew twice as fast, as the growth of both facilities at this time last year."[6]

Pacific's market in these high value services is booming. These are the type of high volume, high value services that should face the first impact from the Commission competitive policies.

Targeted promotions to consumers increased sales of custom calling services beyond the 7.5 million mark, an increase of 23.4 percent. Call Return, for example, which Pacific Bell introduced on a "pay-per-use" basis in April, is producing more than $5 million of revenue per month. Voice mailboxes in service reached 1.6 million as of the end of the second quarter 1996, generating year over year growth of 24.0 percent. In July, Pacific Bell also launched its Caller ID service, which has experienced tremendous success in other regions and which Pacific anticipates to be a $50 million market in two years. Because of the strong growth in these and other service Pacific faced an increase in Other Service Revenues of 6.4%.[7]

Revenues for Pacific increased for the first half of 1996 by $242 million over the same period last year. Revenues for the first half of 1996 exceed 51% of the revenues the company received in 1994 prior to IRD and IntraLATA toll competition. Given the rate of growth in so many areas of the services offered by Pacific Bell, it is very likely that Pacific Bell revenues will be stronger than prior to the introduction of competition.

After reviewing this publicly available information, I can find no reason to conclude that Pacific's financial integrity is at risk because of our local competition rules, nor can I find that given these earnings and revenue figures that Pacific's opportunity to earn has been impaired. In my view, the financial condition of Pacific is healthy and growing.

The constitution of the United States, as amended by the bill of rights protects against the confiscation of property by government has come to mean that regulators must not regulate in a fashion that denies an individual or a corporation a fair return on capital dedicated to public service and subject to regulation. I have taken a solemn oath to up-hold this constitutional

[6] Pacific Telesis July 18, 1996 Press Release

[7] Ibid

protection. This commission has an obligation to regulate in a manner that prevents such a taking of public property. I believe we have. The rules we have adopted for local competition and the rules governing our regulation of the incumbent local exchange carrier provide the utility with a fair opportunity to earn. If I believed otherwise, I would be obligated to revise those rules so as to allow for such an opportunity.

If Pacific or GTEC felt that the Commission's decisions regarding depreciation had deprived it of an opportunity to earn a fair return, Pacific should have filed for a rehearing of those decisions which established the depreciation schedules currently in place. However, Pacific did not file such an appeal. Hence, they should not be allowed to argue that that past decision resulted in a taking. In fact, this Commission clearly stated its intention to open all markets to competition by January 1, 1997 in November and December of 1993. Since that time, the LECs have had two opportunities to file represcription applications. The Commission has acted on both of those, granting the requests of the utilities. Yet, the incumbent LEC's have not sought to appeal these decisions.

The Commission explicitly outlined the parameters under which conditions Pacific and GTEC could apply to increase their rates. GTEC and Pacific would be allowed in increase their rates if their earnings fell below a certain benchmark for two consecutive years. This framework was not found to be unreasonable or unfair.

On the issue of which earnings should be counted in determining the "total picture" of the change wrought by the recent changes in the regulation of the telecommunications industry, the decision of the majority concludes that we look exclusively to those lines of business subject to Commission rate- setting. This approach excludes revenues from those services which have been moved to category III under NRF, as well as those which were not part of the historical scope of the regulated business. I am concerned that included within this excluded category are the revenues that the LEC anticipates earning as a long-distance carrier. If this is the case, the majority would have us ignore the prize which Pacific sought as the animating goal of the very changes it confronts. In reaching this conclusion, the majority relies upon *Calfarm Insurance Co. v. Deukmejian*, 48 Cal3d 805(1989). Reliance on this decision is misplaced. In *Calfarm*, the insurance companies subject to proposition 103 sought to exclude from the affects, test lines of insurance which they had historically offered, but which fell outside the terms of the approved initiative. The majority decision seeks to exclude from the consideration of whether our evolving regulatory scheme allows the utility a fair opportunity to earn benefits which accrued to Pacific as a result of the change. Parties that present us with a claim for compensation for the pain caused by local competition but also ask us to ignore the gain that was explicitly part of the "deal" seek to draw a veil of fiction over the face of fact. Such an approach is anti-factual and ignores the symmetrical *quid pro quo* of the opening ALL markets to competition which was and is the commission's policy.

Balancing the Interests of All

I feel that is my obligation, and the obligation of this commission to review the claims made by the incumbents with the greatest of care. Just as we are obligated to allow these carriers an opportunity to earn a fair rate of return, we are also obligated to protect the public interest and to insure that the rates for telecommunications services offered by these LECs and others remain "just and reasonable".

There is only one way that Pacific Bell can recover costs associated with "franchise impacts" and that is by raising the cost of telecommunications services in California. Either Pacific Bell is allowed to raise its own rates, or the Commission will allow recovery via a All End-User Surcharge (AEUS). Either way, the cost of telecommunications services in California will increase. Allowing Pacific to recover so called impaired investments will have the same impact on the state's economy as a tax and an increased hurdle for new entrants into the market.

Such recovery will raise the cost of telecommunications in California. This will negatively impact those California businesses that are in telecommunications intensive businesses, including the rapidly growing but nascent multi-media and Internet services businesses, the most promising sectors of our economy. Not only will higher telecommunications prices negatively impact the information age industries upon which California's future rests, inflated prices adversely impacts this sector disproportionately relative to other industry sectors.

Moreover, the increased price of telecommunications that would result by granting the LEC request for franchise impacts would have the result of lowering the disposable income of California. This will have a secondary effect of lowering the demand for other goods and services in California and reducing the profitability of California companies.

There can be no doubt that the higher rates that result from compensation will result in fewer jobs and will hinder economic growth and investment in California. The only debate is by how much. We do not know the magnitude of the impact granting compensation for local competition will be. However, we do know, with certainty that it will dampen economic growth, and job creation.

The decision of the majority creates a great deal of uncertainty in the marketplace. This level of uncertainty will serve as a barrier to entry in California. Potential entrants need to know, with some certainty the regulatory structure in the marketplace. The decision of the majority leaves the question of franchise impacts hanging over the marketplace for a period of time that feeds investment uncertainty.

If compensation is granted, the competitiveness of the market may be compromised, if other entrants are forced to bear the cost of recovery. For example, if compensation is granted and the funds are raised via a end-user surcharge, rather than recovery through the rates of the LEC, new entrants will face this cost. Hence this cost would be a barrier to entry.

For this plethora of reasons, I believe that the Commission must carefully weigh the claims of the incumbent LEC's claiming compensation for our regulatory program. We, as a Commission, have an obligation to balance the interest of the public with that of the carriers we regulate. We, as a Commission, have an obligation to promulgate rules for local competition that are fair to all competitors, not just the incumbents. We, as a Commission, have an obligation to ensure we set rates at levels that are just and reasonable yet provide an opportunity to earn a fair return. Unlike the majority, I believe that we have done so. I am convinced that our current regulatory structure provides the incumbent monopolies the opportunity to earn a fair return on their investment as required by the Constitution of the United States. If I believed otherwise, I would not have voted for our rules governing the opening of local markets to competition.

In conclusion, the scope of this proceeding was limited to "the issue of whether the rules that permit local exchange competition alter our regulatory program so that it no longer affords pacific and GTEC an opportunity to earn a fair return on invested capital." (D.95-07-054, slip op., pp 33.) In addition, the objective of the case was not to determine the extent of any takings, rather simply to determine if our regulatory program affords Pacific and GTEC and opportunity to earn a fair rate of return.

The majority reaches the conclusion that "We cannot find at this time that our local competition rules have changed our regulatory structure so drastically as to have violated our obligation to ensure an opportunity to earn a fair return on investment and a fair opportunity to recovers invested capital for either GTEC or Pacific." (Conclusion of Law 71.) I also reach that conclusion. However, I differ from my colleagues who voted in the majority, allowing the incumbent monopolies another chance to reassert their claims, claims that may produce results that may chill the growth of competition in the telecommunications sector and its allied sectors throughout the California economy.

Dated September 20, 1996 in San Francisco, California.

/s/ Jessie J. Knight, Jr.
Jessie J. Knight, Jr.
Commissioner

ATTACHMENT 2

Baby Bells Rely on Specialty Services for Solid Earnings

By Bloomberg News

Four regional telephone companies yesterday reported generally healthy earnings for the fourth quarter, bolstered by profits from caller ID, call waiting and other specialty services.

The four Baby Bells — the Pacific Telesis Group, SBC Communications Inc., the Nynex Corporation and the Bell Atlantic Corporation — have also been plowing the money into efforts to battle the AT&T Corporation and others in the lucrative long-distance arena.

"They are taking full advantage to market these very profitable services and use that money to fund their future lines of business, mainly long distance," said Boyd Peterson, an analyst with the Yankee Group, a market researcher in Boston.

Pacific Telesis, based in San Francisco, said it earned $191 million, or 45 cents a share, down from $231 million, or 54 cents a share, in the quarter a year earlier, a drop of 18 percent.

But the most recent quarter included a gain of $2 million from new accounting methods and charges totaling $93 million. Without the gain and the charges, Pacific Telesis earned $282 million, or 66 cents a share, higher than Wall Street expectations of 58 cents a share, according to a survey of analysts.

Sales from custom calling features propelled the rise in earnings. The company had an 11 percent increase in such services for the quarter.

Pacific Telesis is set to be acquired by SBC Communications, based in San Antonio. The California Public Utilities Commission is expected to rule on the $16 billion acquisition within two months.

SBC earned $542.9 million, or 90 cents a share, up from $517 million, or 83 cents a share, in the quarter a year earlier, a rise of 7.5 percent.

SBC was expected to earn 91 cents, based on the average estimate in a survey of 17 analysts.

The company added 156,000 phone lines in the quarter, up from 149,000 a year earlier. It also added 1.9 million wireless long-distance customers for the year, which represented 42.5 percent of its wireless customer base.

The companies are gearing up to battle AT&T in the long-distance market.

The company said revenue rose 9.5 percent, to $3.8 billion.

The Nynex Corporation, based in New York, earned $379.7 million, or 86 cents a share, up from $235.6 million, or 55 cents a share, in the quarter a year earlier.

Profit from operations at Nynex rose to $416.5 million, or 95 cents a share, from $378.7 million, or 88 cents a share, in the period a year earlier, an increase of 10 percent. Revenue rose less than 1 percent, to $3.33 billion from $3.30 billion.

Results beat an average estimate of 94 cents a share, based on a survey of 15 analysts.

Operating expenses at Nynex fell to $2.62 billion from $2.81 billion as it focused on improving its service — an important step in the planned combination with Bell Atlantic.

Bell Atlantic, based in Philadelphia, agreed to buy Nynex last April in an acquisition valued at $21.9 billion. The companies expect the transaction to close by April.

Nynex installed 3.5 percent more phone lines in its Northeast region. Its wireless venture with Bell Atlantic added one million wireless customers.

Bell Atlantic said it earned $345.6 million, or 79 cents a share, compared with $391.9 million, or 89 cents a share, in the quarter a year earlier, a drop of 12 percent.

Profit from operations rose to $424.4 million, or 97 cents a share, from $395.4 million, or 90 cents a share, an increase of 7 percent.

The results matched the average estimate of 97 cents in a survey of 16 analysts.

The company told analysts it expected to be providing long-distance service to its local phone customers in the third quarter.